The Incentives Paradox

Toggling between long-term strategy and short-term earnings pressure
Anybody can manage short, and anybody can manage long. Balancing those two things is what management is

--Jack Welch, former Chairman and CEO, GE
What is short-termism?

• “The excessive focus of decision-makers on short-term goals at the expense of longer term objectives” Ernst & Young Poland Report

• What suffers?
  – Strategy
  – Fundamentals (ROA, ROIC)
  – Human capital
What drives it?

• Every pundit has a view
• And every pundit cites different research, most of which is contradictory
• BUT some common drivers are...
  – Incentive plans of asset managers and executives
  – Decreasing CEO tenure
  – Frequency and nature of CEO communication
  – “Transient” investors
• Plus:
  • new technologies
  • globalization of financial markets
  • reduced trading times and transaction costs
  • market volatility
  • omnipresent media
  • increasing role of institutional investors
  • shareholder activism
Emerging regulation/standards don’t help

- Relentless focus on relative TSR (see proposed SEC regs on disclosure) – “every dog has his day”
- Negative proxy advisor view of CEO contracts potentially influencing reduction in tenure
- Fixation on performance-based pay: emerging research suggest no meaningful correlation with results
Is this problem solvable?

• NO

  “It’s unrealistic to expect most CEOs of publicly listed companies to ignore short-term pressure from the financial markets...The only way to foster meaningful change is to enlist pension funds, mutual funds, and other large investors in the cause.” Dominic Barton, Mckinsey and Co, with Mark Wiseman, head of Canada Pension Plan Investment Board
NO...

• “Too many investment managers...focus excessively on quarterly performance relative to their benchmark and competing funds...People do what they are rewarded for doing...” Alfred Rappaport, Saving Capitalism from Short-Termism

• “The world would be a better place if businesses stopped thinking so much about short-term results and focused more on the long term...Yet it has proved nearly impossible to shift their behavior...” Adi Ignatius, Harvard Business Review
...Or maybe

- Lengthen CEO tenure and focus on long-term investment *EY Poland Report*
- Abandon the notion of growing shareholder value – a money-maker for the C-suite – and focus instead on investing in the future and in talent *Roger Martin, Fixing the Game*
- Lengthen time horizons of comp packages for executives and asset managers, stop projecting quarterly earnings and limit empty voting by transient investors *Robert Pozen, Curbing Short-Termism in Corporate America: Focus on Executive Compensation*
How can compensation tools help?

• Lengthen **time horizon** of performance plans
• Stick with **consistent performance measures** – companies with consistent measures 5+ years outperformed peers
• Choose the **right measures**

*IF YOU CAN FIGURE OUT WHICH ONES THEY ARE!*
• Dodd Frank proposed pay vs performance disclosure. 5-year table showing actual pay for CEO/NEOs compared to SCT data and cumulative TSR of company/peer group.

• Critical ISS measure

• BUT – abundant research suggests limited value in motivating executives, rewards volatility rather then performance, low correlation with strong returns
EPS?

• Research suggest EPS more strongly related to strong TSR and relative TSR or capital efficiency measures

• BUT – EPS can be distorted by accounting changes, mergers and acquisitions; disregards debt and leverage; and has been shown to be relatively vulnerable to management manipulation
What’s left?
A combination of measures

• Growth plus capital efficiency (e.g., ROIC) – Greg Arnold & Barry Sullivan, Semler Brossy

• Capital efficiency plus EPS – James Reda & David Schmidt, FEI Daily

PLUS

• Longer time horizons on incentive plans, more deferred cash
Board Role

• Set metrics, measures and duration of incentive plans that support longer term behavior
• Support management to develop sound long-term strategy that drives value
• Challenge management to articulate powerfully the strategic rationale and communicate regularly with key shareholders
• Avoid constant focus on the share price and help CEO balance short term pressures against investment in the longer term
Beyond compensation...

• Growing coalition of leaders is calling for a more holistic approach

• Aspen Institute Business & Society Program has called for:
  – Market incentives that encourage patient capital
  – Aligning interests of financial intermediaries and investors
  – Strengthening investor disclosures
• Redefining corporate purpose – support policies that move away from purely shareholder-centric primacy
  – Gear comp to longer term
  – Measure and monetize abstract matters to balance share price
  – Simplify tax code
  – Focus on clear mission and alignment with strategy
  – Foster transparency and shift tone of communications
  – Increase employees’ role in decision-making
  – Make leadership attraction and training a priority
  – Make reputation a higher priority, measure and track it
  – Explore new ways of forming corporations
  – Attach different rights to long vs short-term shareholders
Useful references

- Dorf, Michael, *Indispensable and Other Myths*, University of California Press 2014
- *Short-termism in business: causes*, EY Poland Report 2014
- Pozen, Robert, *Curbing Short-termism in Corporate America*, Governance Studies at Brookings 2014
- “Why Can’t We End Short-Termism?”, *Forbes* 7/22/2014
- “TSR Can Be a Flawed Incentive Measure”, Semler Brossy Insights, 5/27/2015